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ABSTRACT

This self-instructional module on assessing the health of your business is the eleventh in a set of twelve modules designed for small business owner-managers. The competency for this module is to assess the financial condition of your business. Provided are information sections (key business records, balance sheet and profit and loss statements, and four basic questions when examining the balance sheet and the profit and loss statement); one learning activity (a balance sheet and profit and loss statement exercise); three pamphlets from the Small Business Administration ("Controlling Cash in Small Retail and Service Firms," "Analyze Your Records to Reduce Costs," and "Is Your Cash Supply Adequate?"); and a script for a cassette tape designed for use with this module. (The final report of this project is available as CE 017 858.) (JH)

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SCRIPT

ASSESSING THE HEALTH OF YOUR BUSINESS

INTRODUCTION:

Periodic examination fo the health of your business can be useful for developing plans and making decisions. Just as a doctor reviews your medical records and performs tests to determine your physical condition, you can measure the health of your business by examining the financial records and by testing these records against measures of financial success.

Let's listen to what Frank Walker, an experienced owner-manager of a shoe store, Bob Perez, the operator of a bookkeeping service, and Lou Simmons, Frank's friend who has just started a small wholesale industrial supply firm, have to say about the use of financial records. The three men are in Bob's office.

Frank: Bob, I'd like you to meet Lou Simmons. Lou is just finishing his first year as a wholesaler of industrial supplies.

Bob: Lou, pleased to meet you.

Lou: My pleasure, Bob.

Bob: Why don't we sit down and make ourselves comfortable? (SOUND OF CHAIRS SLIDING) Lou, are you enjoying your first year as a small business owner-manager?

Lou: It has been exciting and at times rather hectic, but generally a rewarding experience.

Frank: Speaking of rewarding experiences, Bob, Lou is interested in finding out exactly how well his business is doing.

Lou: What I'm interested in Bob, is for you to review my records and prepare my financial statements.

Bob: Lou, I'd be pleased to take you on as a client. Generally when I first meet with a new client I like to take a few minutes to discuss the use of records and financial statements. Do you have some time today?

Lou: I do if Frank does.

Frank: That's fine with me.

Bob: Okay, Lou? It's been my experience that many business persons keep records and have financial statements made for tax purposes only. Once they know they've made a profit and have paid the IRS, the records are filed away.

Frank: What you're saying is that the "bottom line"--whether the business made a profit or loss--is not enough.

Bob: That's right. Records and financial statements can be used to measure the health of a business and profit is only one of many measures that can be used. An owner of a small firm can use the records to determine the present condition of the business and also to decide on steps to prevent poor results in the future.

Lou: Sounds like when I go to the doctor for my physical. Sometimes he finds something wrong with me and prescribes medicine, while at other times he says I'm OK--but if I don't change some of my ways I'll pay for it later on.

Bob: Exactly

Lou: Now that I understand that, what records should be examined?

Bob: Probably the two most important are the (1) balance sheet and (2) the profit and loss statement. These statements are known by different titles, but the balance sheet can be recognized by its grouping of assets, liabilities, and owners equity and the profit and loss statement records revenues, expenses, and net income.

Frank: I'm pretty familiar with the profit and loss statement, isn't that the same thing as the income statement?

Bob: You're right. Remember, no matter what it's called it is used to record revenues--or sales--and expenses: and the bottom line is the net income.

Frank: And the balance sheet lists (1) the assets of the business, (2) the liabilities--which are the debts of the business, and (3) the owners equity--which is how much I've got in the business.

Bob: That's a pretty good definition.

Lou: When I'm looking at those records, what should I look for?

Bob: Generally you should ask yourself four questions. (1) What rate of return am I receiving for my investment of time and money? (2) How profitable is my business operation? (3) Am I able to pay my current debts? (4) Do I have a satisfactory inventory turnover?

Lou: I've heard of those, would you explain them a little more?

Bob: Sure, I'll start with rate of return. Let's say a person has $10,000 to invest. That money could be placed in a savings account where in a years time it might earn $700 interest. That $700 is the return on the investment and is approximately a 7% return. Okay?

Lou: Yes, I follow you.

Bob: Now, let's say that a person takes the $10,000 and starts a small business instead of putting it into a savings account. The return expected on the investment is not called interest, but...

Frank: Profit, I'll bet it is the profit the business makes.

Bob: Right. And if the business makes a $1,00 profit that year the owner has earned a 10% rate of return because $1,000 is 10% of $10,000. (PAUSE)

Lou: So what you're saying is I should look at my statements and figure my rate of return. Then to determine the health of my business I should compare my rate of return with the rate earned by similar businesses, or other investments.

Bob: Right again.

Frank: Now, what about profitability?

Bob: Many owners are interested in the profits--the dollar amount of profits. No question that the dollar amount is an important measure, but profits should also be stated as a percentage of sales.

Lou: Why as a percentage?

Bob: This allows the owner to compare the percentage figure with that of similar businesses. Dollar amounts of profit are not easy to locate, but many trade associations publish industry averages which report profits as a percentage of sales.

Frank: So, profitability is another measure of the health of my business. Profitability measured in dollars and as a percentage of sales. (PAUSE) Bob, earlier you mentioned records to determine debt paying ability. What measure should be used?

Bob: There are several--but one is the "Acid Test" also known as the "Quick Ratio."

Frank: How does it work?

Bob: Basically it's a comparison of a firm's "quick assets" with its current liabilities.

Frank: Quick assets? I don't understand what you mean.

Bob: They are the assets of a business such as cash and other assets readily changed into cash like accounts receivables. Most people arrive at the quick assets figure by subtracting the inventory figure from the current assets total. This total is then compared to the liabilities of the business which are due within the next year.

Lou: I can see where that will give an idea of the firm's ability to pay its bills. (PAUSE) What about inventory turnover you mentioned earlier.

Bob: Inventory turnover is a measure of the speed with which your inventory is sold. The turnover rate varies among different types of businesses but industry averages have been established. A turnover of, say twelve times, indicates that your entire inventory is sold twelve times a year. If your turnover is less than twelve it may indicate some slow selling items.

Frank: I've found it important to get rid of merchandise that won't sell. Inventory turnover is a valuable measure.

Bob: It is. In fact all the measures we've mentioned: rate of return, profitability, acid test, and inventory turnover are valuable tests for measuring the health of your business.
But they're just the start. There are many more like

FADE INTO SILENCE

CONCLUSION:

You've just listened to Frank Walker, Bob Perez, and Lou Simmons, discussing the examination of business records. The Balance Sheet and the Profit and Loss Statement were mentioned as important sources of information regarding the health of a business. Bob identified rate of return, profitability, acid test, and inventory turnover as valuable measures of business performance.

Now proceed to the written materials for more information.
Turn to page 2.

PURPOSE

Either as a form of preventive medicine, or on the advice of your doctor, you periodically submit yourself to a physical examination. From the examination results your doctor can: (1) assess your health and (2) prescribe a treatment to maintain or improve your health status. Similarly, you should submit your business to a health examination. Assessing the health of your business will enable you to plan a course of action to insure that your business remains healthy. The purpose of this module is to (1) point out those business records which should be periodically examined, and (2) identify the types of information you should gather from these records.

COMPETENCIES

Upon completion of this module, you will be able to:

1. Assess the financial condition of your business.

INSTRUCTIONS

Before reading the material which begins on page 2, listen to the cassette entitled "Assessing the Health of Your Business."

KEY BUSINESS RECORDS

Your business, like yourself, is susceptible to periods of ill health. When you are coming down with an illness, your body warns you with various signals. Similarly, your business records can serve as indicators of your firm's health. Careful and periodic examination of selected business records will reveal the type of information you need to keep your business healthy. But what records do you examine?

Two business records containing vital information are the:

1. Balance Sheet
2. Profit and Loss Statement (Sometimes called the Income Statement)

BALANCE SHEET
HALE'S AUTO PARTS AND SERVICE
December 31, 1976

Current Assets		Current Liabilities	
Cash	$ 7,000	Accounts Payable	$ 5,000
Accounts Receivable	15,000	Notes Payable	12,000
Inventory	15,000		
Total Current Assets	$37,000	Total Current Liabilities	$17,000
Fixed Assets		**Long Term Liabilities**	
Equipment	$ 7,000	Notes Payable	$ 5,000
Total Fixed Assets	7,000	Total Long Term Liabilities	5,000
		Total Liabilities	$22,000
		Owner's Equity	22,000
Total Assets	$44,000	Total Liabilities and Owner's Equity	$44,000

The balance sheet represents the financial condition of your business on a particular date. Not only is the balance sheet useful for management evaluation, it is required for some tax purposes and banks require it for evaluation of loan requests.

PROFIT AND LOSS STATEMENT

HALE'S AUTO PARTS AND SERVICE

For period ending December 31, 1976

GROSS SALES		$87,000
COST OF GOODS SOLD		
Beginning Inventory (Retail = $27,000)	$17,000	
Purchases	52,000	
Cost of Goods Available for Sale	$69,000	
Less Ending Inventory (Retail = $24,000)	15,000	
COST OF GOODS SOLD		54,000
GROSS PROFIT		$33,000
OPERATING EXPENSES		
Payroll	$14,000	
Rent	3,200	
Payroll Taxes	1,150	
Interest	3,430	
Depreciation	450	
Delivery Expense	1,180	
Telephone	970	
Insurance	700	
Miscellaneous	2,500	
TOTAL OPERATING EXPENSES		$28,500
NET PROFIT (Before Owner's Salary)		$ 4,500

The Profit and Loss Statement summarizes the amounts and kinds of income and expenses, along with the resulting income or loss incurred during a particular time period. Apart from its importance as a vital source of information for management evaluation purposes, the Profit and Loss Statement is also required for tax purposes and banks require it for evaluation of loan requests. Both the Balance Sheet and Profit and Loss Statement are essential to measuring the health of your business.

Whether you maintain your own business records or subscribe to a bookkeeping service, four basic questions need to be answered:

1. What rate of return am I receiving for my investment of time and money?

2. Compared to similar businesses, how profitable is my business operation?

3. Am I able to meet my current debts and still take advantage of supplier discounts?

4. Do I have a satisfactory inventory turnover?

Careful examination of both the Balance Sheet and the Profit and Loss Statement (along with simple arithmetic) will provide you with the information needed to answer these questions.

A. 1. To determine the rate of return you are receiving on your business investment, locate the Net Profit figure on the Profit and Loss Statement. This figure represents the profit remaining after all expenses have been paid.

2. Next, locate the Owner Equity figure on the Balance Sheet. This figure represents the investment of the owner and any earnings generated from the operation of the business.

3. Now divide the Net Profit figure by the Owner Equity figure and state the result as a percentage. Compare this rate with that of similar businesses in the publication Key Business Ratios included with this module.

$$\frac{\text{NET PROFIT}}{\text{OWNER EQUITY}} \quad \frac{\$\ 4500}{\$22000} = 20.45\%$$

B. 1. To calculate the profitability of your business, locate the Net Profit figure on the Profit and Loss Statement.

2. Next, locate the Sales figure on the Profit and Loss Statement.

3. Divide the Net Profit figure by the Sales figure and state the result as a percentage. Check your answers. Compare this figure with that of similar businesses. Are your sales generating sufficient profit?

$$\frac{\text{NET PROFIT}}{\text{SALES}} \quad \frac{\$\ 4500}{\$87000} = 5.17\%$$

C. 1. Do you have sufficient funds to pay your debts as they come due? How rapidly can you convert your assets into cash? To measure your ability to pay debts when they are due, first locate on the balance sheet (1) the current assets figure, (2) the inventory figure, and (3) the current liabilities figure.

2. Set up the following formula to find your answer:

$$\frac{\text{Current Assets - Inventory}}{\text{Current Liabilities}}$$

3. Check your answer. A result of 1.0 is considered satisfactory, which means that for each $1.00 in indebtedness, you have the equivalent of $1.00 in cash to pay these debts.

$$\frac{\text{Current Assets } \$37{,}000 - \$15000 \text{ Inventory}}{\text{Current Liabilities } \$17000} = 1.29$$

D. 1. Is your inventory turnover satisfactory? The number of times your inventory is sold during a certain period of time can effect your profits. To determine your inventory turnover, first determine the retail value of the beginning and ending inventory figure on the Profit and Loss Statement.

2. Add the retail value of the beginning and ending inventory figures and divide by 2. The result is called the average inventory at retail.

3. Next, locate the Sales figure on the Profit and Loss Statement. Divide this figure by the average inventory at retail. The result is your inventory turnover.

$$\text{Average Inventory} = \text{Beginning Inventory } \$27{,}000 + \text{Ending Inventory } 24{,}000 = \$51{,}000 \qquad \frac{\$51{,}000}{2} = \$25{,}500 \text{ Average Inventory}$$

$$\text{Inventory Turnover} = \frac{\text{Sales}}{\text{Average Inventory}} = \frac{\$87000}{\$25000} = 3.45 \text{ Inventory Turnover}$$

What does all this mean? If you will compare each of the figures you obtained with the figure obtained by similar businesses, you can evaluate the business performance of Hale's Auto Parts and Service. Similarly, you can compare your own business performance with that of similar businesses. A chart of business measures(ratios) is included in the preferred readings to enable you to make a comparison.

NOTE: Please turn to page 6 and complete learning activity number one.

LEARNING ACTIVITY NUMBER ONE

DIRECTIONS:

To provide you with an opportunity to apply the concepts presented in this module, we have provided you with both the balance sheet and profit and loss statement for Hager's Florist Shop. (See illustration on the following page.) After reviewing these two financial statements, answer the following questions:

1. a. What rate of return is Hager's Florist Shop receiving?
   b. How profitable is the business?
   c. Is the business able to meet its debts?
   d. What is the rate of inventory turnover?

2. How does each answer compare with that of similar businesses listed in the preferred readings?

3. Explain the reason(s) for any differences in figures observed between Hager's Florist Shop and similar businesses.

Check your answers with those provided below.

Answers: a. 45% b. 12% c. 2.79 d. 3.2

LEARNING ACTIVITY NUMBER ONE--continued

THE HAGER'S FLORIST SHOP
BALANCE SHEET
December 31, 1976

Current Assets		Current Liabilities	
Cash	$1200	Accounts Payable	$ 750
Accounts Receivable	4300	Notes Payable	1220
Inventory	3000		
Total Current Assets	$8500	Total Current Liabilities	$1970
Fixed Assets		Long Term Liabilities	
Equipment	$3500	Notes Payable	$1500
		Owners Equity	8530
Total Assets	$12000	Total Liabilities	$12000

THE HAGER'S FLORIST SHOP
PROFIT AND LOSS STATEMENT
For Period Ending December 31, 1976

GROSS SALES		$32000
COST OF GOODS SOLD		
Beginning Inventory (Retail=14,000)	$ 7000	
Purchases	12000	$19000
Ending Inventory (Retail=6,000)		3000
COST OF GOODS SOLD		$16000
GROSS PROFIT		$16000
OPERATING EXPENSES		
Payroll	$4520	
Payroll Taxes	320	
Supplies	1400	
Advertising	320	
Interest	200	
Delivery Expense	3710	
Telephone	700	
Insurance	350	
Miscellaneous	640	
TOTAL EXPENSES		$12160
NET PROFIT (Before owner's salary)		$ 3840

PREFERRED READING LIST

This instructional module is designed to introduce key concepts regarding ways to assess the health of your business. For a more in-depth examination of this topic area, study the following preferred readings.

SMALL BUSINESS ADMINISTRATION SMALL MARKETERS AIDS

#110 "Controlling Cash in Small Retail and Service Firms"

#130 "Analyze Your Records to Reduce Costs"

SMALL BUSINESS ADMINISTRATION MANAGEMENT AIDS

#174 "Is Your Cash Supply Adequate"

DUN AND BRADSTREET

"Key Business Ratios"

NOTE: You have now completed the module requirements. You may wish to review this module or advance to another module.

SMALL BUSINESS ADMINISTRATION • EUGENE P. FOLEY, Administrator
U. S. Government Agency

SMALL MARKETERS AIDS No. 110

WASHINGTON, D.C. February 1965

CONTROLLING CASH IN SMALL RETAIL AND SERVICE FIRMS

By D. S. Campbell

Financial Vice President, J. J. Newberry Company, New York, New York

SUMMARY

Owners of small retail and service firms are often hampered by the lack of cash. Or almost as harmful, they sometimes lose opportunities by allowing excess cash to lie idle.

The secret of controlling cash is having the right amount on hand and in using surpluses wisely, when they occur. This Aid discusses four steps which the small business owner may find helpful in controlling his cash. They are: (1) keeping adequate records on cash--book control; (2) knowing the cash flow pattern of the firm; (3) estimating future cash balances; and (4) using excess cash to produce income.

Cash is a problem for many small marketers. As George Blue*, who operates a small appliance repair shop says, "I never seem to have enough cash. Often I have to slight one creditor to pay another."

On the other side of town, John Alma has a different kind of problem with operating cash. In his neighborhood shoe store, he often has extra cash. "At times I have more cash than my business needs," he says.

Both of these small business owners are missing the secret of how to control their cash.

THE RIGHT AMOUNT

The secret of controlling cash can be stated in one word: Balance. A firm should aim to have just the right amount of cash on hand--never too little for its needs and never too much for its needs.

When a business has a permanent year-around pressure on cash, as did Mr. Blue, that firm may be undercapitalized. Such a chronic shortage of cash can lead to disaster because the owner can't pay the firm's bills when they are due. Or the firm may go broke because its owner lacks the financial resources to meet the sudden demands of new cut-throat competition. Mr. Blue needs to get more capital into his firm because his present investment does not generate enough cash to keep the business financially healthy.

On the other hand, an excess amount of cash--as in the case of Mr. Alma, often indicates that the small marketer is not using his liquid assets properly. Mr. Alma could use his excess cash, for example, to stock new, profitable lines which would help his business to grow. Or he might invest his excess cash in short term securities which could be redeemed when his firm needed funds. And if he should accumulate fairly large amounts of excess cash on a regular basis, his best investment probably would be that of plowing the money into modernizing his firm--into remodeling which will help attract a greater number of customers.

Control of cash involves two paths of action. The first is having the right amount on hand to pay your bills. The second is using any excess of that amount wisely.

Book control--your day-to-day and month-by-month accounting--governs your journey on both paths. It tells you how much money you have available, how much you need to pay your bills, and whether there is a deficit to be made up or a surplus to be invested. In the latter case, you may sometimes have to take prudent risks--as do all successful business owners--in order to make your cash balances produce income.

One approach to sound cash management involves four steps: (1) making sure that your book control works properly, (2) determining the cash flow pattern for your business, (3) estimating future cash balances, and (4) using excess cash to produce income.

CHECK YOUR BOOK CONTROL

Some owners of small retail and service firms find the going rough because they fail to

*All names in Aids are disguised.

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make a smooth path in the first phase of cash management. They try to operate without adequate book control.

In thinking about your control over cash, start by checking your present way of keeping books. Are your records on cash adequate? Do they tell you what you need to know about the cash that comes into your business? Do they tell you what you need to know about the cash which goes out of your business? Do they alert you to cash deficits? To cash surpluses?

Keep in mind that such records do not have to be elaborate. However, they should account for every penny of cash coming into your firm and for every penny of cash going out. Even a one-man business--with no employees--should keep books on all receipts and disbursements.

• Facts About Cash

In checking the kinds of records you use to control cash, it may be helpful to keep in mind the following facts about cash.

Cash usually comes from four sources: (1) daily cash sales, (2) payments which customers make on their accounts, (3) loans which you arrange to meet short-term needs, and (4) additional capital which you borrow on a long-term basis.

On the out-going side, cash is used for at least six things: (1) to pay for inventory, (2) to pay personnel, including the owner-manager's salary, and his profit--return on investment, (3) to reduce accounts payable--to pay for things, other than inventory, which you bought on credit, (4) to liquidate loans, (5) to pay rent, and (6) to pay for utilities and other overhead expenses.

Good control over stock is important in controlling cash. Your aim should be to have adequate stock for serving customers without tying up money in unnecessary inventory. For additional information, you may want to read "Basic Stock Control for Small Stores" in *Small Marketers Aids Annual* No. 1, 1959, Small Business Administration, available for 45 cents from the Superintendent of Documents, Washington, D.C. 20402.

• Tips For Book Control

Keeping track of the cash that comes into your business requires two things: (1) procedures and records which will help you to safeguard the funds and (2) attention to the details necessary to keep those procedures working. The following suggestions should be helpful as you check your situation with the goal of making a smooth path for the book control of your cash.

• Guide your activities by the rule that handling business cash as though it belonged to someone else is vital to a firm's success--especially when your firm's cash is limited.
• Keep personal cash separate from cash generated by your business. One way to do it is by paying yourself a weekly or monthly salary.
• Keep a record of all incoming cash. It should be a simple one which will show you: (1) the amount of cash, (2) the date received, and (3) the source.
• Use a bank account for your business funds.
• Deposit all cash receipts in your firm's bank account.
• Never make a disbursement out of your daily cash receipts.
• Deposit each day's cash receipts intact on a daily basis.
• Pay all bills, if possible, with checks. They provide a record and serve as a control. Checks also help you to keep disbursements in coin and currency to a minimum.
• Use a petty cash fund if you do have to pay some small bills in coin and currency. This fund should be a fixed amount and balanced regularly. Get a properly signed receipt when making a payment from the petty cash fund. Reimburse your petty cash fund with a check which notes, for example, "to cover cash used in paying receipts numbered 21, 22, and 23."
• Make disbursements only if you have (1) a supplier's invoice or (2) a receipted paid-out voucher which is dated and fully signed by the person to whom you give the check (or money if it's a small petty cash expense).
• Keep your records simple. In a busy schedule, you will be more apt to refer to your records if they are easy to use.
• Periodically have your procedures and controls checked by your accountant or a key employee to see that they are working effectively.

DETERMINING YOUR CASH FLOW PATTERN

Book control gives you information which you need on the second path of cash management. On this path, your concern is keeping your business healthy by: (1) providing funds when there are deficits in cash and (2) using surpluses wisely. Here you are working with dynamic situations--ones that change from month to month.

Before a small marketer can achieve efficient use of his cash balances, he has to know his firm's cash flow pattern. He needs answers to the following questions:

How much cash comes into your business each month? How much goes out? Is any left at the end of the month? If so, how much?

You can get your answers by looking at the records which give you book control of cash. See what they tell you about your past cash-flow pattern.

You'll need to use a budgeting technique and look at your records for the past. You may want to ask your accountant or bookkeeper to work out the details for you.

One simple budget technique involves: (1) adding to the cash balance at the beginning of the month estimates of income expected during the next month and (2) subtracting estimates of expenses for the next month. When this is done for 12 months, you have your

expected cash balances for each of the 12 months.

However, at this point, you are not interested in the future. You need to find out what has happened to your cash. This information will be a guide when you start thinking about the future. So look at your cash records for last year and see on a monthly basis: (1) where your cash came from, (2) where it went, and (3) how much was left at the end of each month.

Suppose, for example, that your year starts with January. The first fact you need is the cash balance you had on hand on December 31. Suppose further that this balance was $1,560. Then from your last January records add the following income items to the $1,560:

(1) All payments from customers both against accounts receivables and as cash sales;

(2) Any money received as a loan from a bank or other source;

(3) Additional capital invested in the business; and

(4) All payments received from sale of fixed assets.

To carry the example through, suppose further that the January income items accounted to a total of $3,000. Thus total available cash in January was $4,560 ($1,560 plus $3,000).

The next step is subtracting the January expense items from the $4,560. Subtract the following expense items:

(1) All payments you made against accounts payable;

(2) All expenses paid (not merely accrued);

(3) All cash withdrawals by the owner;

(4) All repayment of loans; and

(5) All payments for fixed assets.

Suppose further that these expenses totaled $2,800. Thus your cash balance at the end of last January was $1,760 ($4,560 minus $2,800).

This $1,760 was your cash on hand at the start of last February. Repeat the process of adding cash income for that February and subtracting cash paid out in order to get your cash balance at the end of February. Do the same for each of the 12 months in that year.

As a final step, you may want to: (1) underestimate cash receipts by 5 percent and (2) overestimate cash payments by 5 percent. Allowing such margins gives you a 10 percent (5 + 5) leeway which helps provide for unforseen expenses and overestimated cash receipts.

- Look For Trouble Spots

The exercise of working up last year's cash balances by months should give you an exact idea of what the cash flow pattern of your business was for that year. However, before trying to predict your cash balances for each month of next year, look again at your records.

This check is for trouble spots. Were there any in last year's operation? For example, were there months when:

(1) Expenses were greater than the gross profit you made from sales.

(2) Cash was inadequate at the start of the month.

(3) There was over expansion of the business without new capital being made available.

(4) There were excessively high accounts receivable which were not discounted at the bank. (You may want to offer a cash discount for prompt payments.)

(5) Cash was reduced below an adequate balance because you had to buy fixed assets--such as new equipment--that are recoverable only through depreciation.

Some of these trouble spots can be caused by seasonal fluctuations. One way to avoid them is by short-term borrowing.

Many owners of small retail and service firms borrow at various times during the year to tide their businesses over months when there are cash deficits. They know that they can pay the costs (interest) of borrowing and repay the loan, and still make a profit on the money they borrowed. Thus they are able to get by with less cash of their own in the business. Such bank loans, for example, enable them to take advantage of the dating on their suppliers' invoices.

- List Your Long-Range Needs

Before you start to plot out how you will improve your control of future cash, take time to list the long-range needs of your firm. List items such as:

(1) Equipment, tools, and other fixed or depreciating assets which will need replacing.

(2) Additional equipment or other fixed assets which you may need in order to hold your own with competition.

(3) Remodeling or expansion of your facilities which may be needed to increase sales and boost your net profit dollars.

You need to have an idea of these long-range requirements so you can provide for them without crippling your cash. Some small retailers fail, for example, to depreciate their fixed assets and set up financial reserves for their replacement. Thus, they have to dip into their cash balances--into funds for paying the firms day-to-day bills--to pay for the replacement of worn out equipment.

Such a situation can be avoided by planning--that is, by trying to chart the course of your business for the next 1 to 5 years. In addition to budgeting for the short range needs, as will be discussed in the next section, you should at least make a tentative plan for handling your firm's long-range needs.

ESTIMATE YOUR CASH BALANCES

At this point, you should be ready to estimate your cash balances for the next 12 months. These estimates are made by working out a budget.

As was discussed in the section, "What Is Your Cash Flow Pattern?" budgeting is a means of forecasting the income and expenses of your

business during the next month, during the next 6 months, and up to the next 12 months.

The knowledge which you gained about your last year's cash flow pattern can be the basis for your estimates of future cash balances.

In looking ahead, keep your peak seasons in mind. Then you can have the cash on hand, or arrange for a loan, to take care of the increased inventory and increased accounts receivable which are part of a peak season.

For additional information on developing a budget, see *A Handbook for Small Finance* and other publications listed in "For Further Information" on this page.

A good rule is to keep your forecasting as simple as possible. Tailor it to your business so it will help you to know the amounts of cash you can expect to have on hand at various times during the next year. It is also a good idea to provide for growth by setting up a reserve fund in accordance with your estimated future sales.

USE BALANCES TO PRODUCE INCOME

Knowing what your cash balances will be--provided things go as you expect them to--helps you to achieve dynamic control of your cash. This sort of control is similar to driving your automobile in a safe manner on a highway. You not only have it under control but are also using it to accomplish a purpose. Cash control helps you in three ways.

First, it guards your cash balances so that they will be available when you need them. For example, resist the temptation to use your cash for new fixtures, or for other fixed assets, which should be paid for out of other funds.

Second, cash control will warn you of the month, or months, when the cash balance is less than expected expenses. Meet this problem head-on by arranging for a short-term bank loan to tide your business over the gap and to its next peak.

Third, knowing your cash balances can help you to determine your rate of growth. It is your roadmap in using cash surpluses. In the month, or months, when your cash inflow is greater than your business needs, be prepared to put that excess cash into something which will earn income.

As was suggested earlier in this Aid, you may want to invest such excess cash in: (1) new lines which can increase sales and profit, or (2) in short-term securities. The important thing when you are just starting is to keep such investments fairly liquid so you can turn them into cash should the need arise. Put the excess cash where you can get it when your business needs it.

If your firm grows to the extent that larger amounts of excess cash are accumulated, you'll probably want to think about putting some of it into investments such as Government securities, savings and loan shares, bank savings, or stocks or bonds recommended by your banker or a reliable investment expert who is familiar with your investment objectives.

FOR FURTHER INFORMATION

Businessmen interested in the subject of controlling cash may wish to consult the following references. This list is necessarily brief and selective. However, no slight is intended toward authors whose works are not mentioned.

A Handbook of Small Business Finance. Small Business Management Series No. 15. 7th ed. 1965. Small Business Administration. Available for 35 cents from the Superintendent of Documents, Washington, D.C. 20402.

"Budgeting for Small Department Stores." *Management Research Summary* No. 153. Free. Small Business Administration, Washington, D.C. 20416.

"Keeping Score With Effective Records." *Small Marketers Aids* No. 94. Free. Small Business Administration, Washington, D.C. 20416.

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ANALYZE YOUR RECORDS TO REDUCE COSTS

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SUMMARY

Increasing profits through cost reduction must be based on the concept of an organized, planned program. Unless adequate records are maintained through a proper accounting system there can be no basis for ascertaining and analyzing costs.

Cost reduction IS NOT simply attempting to slash any and all expenses unmethodically. The owner-manager must understand the nature of his expenses and how his expenses inter-relate with sales, inventories, cost of goods sold, gross profits and net profits.

Cost reduction does not mean only the reduction of specific expenses. You can achieve greater profits through more efficient use of the expense dollar. Some of the ways you do this are by increasing the average sale per customer, by effectively using display space and thereby increasing sales volume per square foot, by getting a larger return for your advertising and sales promotion dollar, and by improving your internal methods and procedures.

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Profit is in danger when good merchandising and cost control do not go hand in hand. A big sales volume does not necessarily mean a big profit, as one small retailer, Carl Jones*, learned.

His pride was stocking stylish and well assorted lines of merchandise. Each year, his sales volume increased. This increase he attributed to good merchandising which he felt took care of the steady rise in expenses.

But Mr. Jones began to have doubts when he found it necessary to get bank loans more often than had been his practice. When he discussed his problem with his banker, he was advised to check his expenses. As the banker said, "A large and increasing sales volume often creates the appearance of prosperity while behind-the-scene expenses are eating up the profit."

PAYING THE RIGHT PRICE

Your goal should be to pay the right price for prosperity. Determining that price for your operation goes beyond knowing what your expenses are. Reducing expenses to increase profit requires you to obtain the most efficient use of the expense dollar.

Names are disguised in Aids.

Look, for example, at the payroll expense. Salesclerks are paid to sell goods, and their productivity is the key to reducing the payroll cost.

If you train a salesclerk to make multiple sales at higher unit prices, you increase his productivity and your profits without adding dollars to your payroll expense. Or if four salesclerks can be trained to sell the amount previously sold by seven, the payroll can be cut by three persons.

An understanding of the worth of each expense item comes from the retailer's experience and an analysis of his records. Adequate records tell what has happened. Their analysis provide facts which can help you set realistic cost and profit goals. When you attain these goals, you are paying the right price for your store's prosperity.

ANALYZE YOUR EXPENSES

Sometimes you cannot cut an expense item. But you can get more use from it and thus increase your profits. In analyzing your expenses, you should use percentages rather than actual dollar amounts.

For example, if you increase sales and keep the dollar amount of an expense the same, you have decreased that expense as a percentage of sales. When you decrease your cost percentage, you increase your percentage of profit.

On the other hand, if your sales volume remains the same, you can increase the percentage of profit by reducing a specific item of expense. Your goal, of course, is to do both: to decrease specific expenses and increase their productive worth at the same time.

Before you can determine whether cutting expenses will increase profits, you need information about your operation. This information can be obtained only if you have an adequate recordkeeping system. Such records will provide the figures to prepare a profit and loss statement (preferably monthly for most retail businesses), a budget, break-even calculations, and evaluations of your operating ratios compared with those of similar types of business.

BREAK-EVEN. A useful method for making expense comparisons is break-even analysis. Break-even is the point at which gross profit equals expenses. In a business year, it is the time at which your sales volume has become sufficient to enable your over-all operation to start showing a profit. The two condensed profit and loss statements, in the accompanying example, illustrate the point. In Statement "A", the sales volume is at the break-even point and no profit is made. In Statement "B" for the same store, the sales volume is beyond the break-even point and a profit is shown. In the two statements, the per-

centage factors are the same except for fixed expenses, total expenses, and operating profit.

	A		B	
	Break-Even Amount	Percent of Sales	Profit Amount	Percent of Sales
Net Sales	$500,000	100	$600,000	100
Cost of Sales	300,000	60	360,000	60
Gross Profit	200,000	40	240,000	40
Operating Expenses				
Fixed	150,000	30	150,000	25
Variable	50,000	10	60,000	10
Total	200,000	40	210,000	35
Operating Profit	$ NONE	0	$ 30,000	5

As shown in the example, once your sales volume reaches the break-even point, your fixed expenses are covered. Beyond the break-even point, every dollar of sales should earn you an equivalent additional profit percentage.

It is important to remember that once sales pass the break-even point, the fixed expenses percentage goes down as the sales volume goes up. Also the operating profit percentage increases at the same rate as the percentage rate for fixed expenses decreases—provided, of course, that variable expenses are kept in line. In the illustration, fixed expenses in Statement "B" decreased by 5 percent and operating profit increased by 5 percent.

LOCATING REDUCIBLE EXPENSES

Your profit and loss statement provides a summary of expense information and is the focal point in locating expenses that can be cut. Therefore, the information should be as current as possible. As a report of what *has already been* spent, a P and L statement alerts you to expense items that bear watching in the present business period. If you get a P and L statement only at the end of the year, you should consider having one prepared more often. At the end of each quarter might be often enough for some firms. Ideally, you can get the most recent information from a monthly P and L.

Regardless of the frequency, for the most information, two P and L statements should be prepared. One statement should report the sales, expenses, profit and/or loss of your operations cumulatively for the current business year to date. The other should report on the same items for the last complete month or quarter.

Each of the statements should also carry the following information: (1) this year's figures and each item as a percentage of sales, (2) last year's figures and the percentages, (3) the difference between last year and this year—over or under, (4) budgeted figures and the respective percentages, (5) the difference between this year and the budgeted figures—over or under, (6) average percentages for your line of business (industry operating ratios) when available, and (7) the difference between your annual percentages and the industry ratios—under or over.

This information allows you to locate expense variation in three ways: (1) by comparing this year to last year, (2) by comparing expenses to your own budgeted figures, and (3) by comparing your percentages to the operating ratios for your line of business.

The important basis for comparison is the percentage figure. It represents a common denominator for all three methods. When you have located the percentage variations, you should then study the dollar amounts to determine what kind of corrective action is needed.

Because your cost cutting will come largely from variable expenses, you should make sure that they are flagged on your P and L statements. Variable expenses are those which fluctuate with the increase or decrease of sales volume. Some of them are: advertising, delivery costs, wrapping supplies, sales salaries, commissions, and payroll taxes. Fixed expenses are those which stay the same regardless of sales volume. Among them are: your salary, salaries for permanent non-selling employees (for example, the bookkeeper), depreciation, rent, and utilities.

TAKING ACTION

When you have located a problem expense area, the next step obviously is to reduce that cost so as to increase your profit. A key to the effectiveness of your cost-cutting action is the worth of the various expenditures.

As long as you know the worth of your expenditures, you can profit by making small improvements in expenses. Keep an open eye and an open mind. It is better to do a spot analysis once a month than to wait several months and then do a detailed study.

Take action as soon as possible. You can refine your cost-cutting action as you go along.

Be persistent. Sometimes results may be slower than you might like. Keep in mind that only persistent analysis of your records and constant action can keep expenses from eating up profit.

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IS YOUR CASH SUPPLY ADEQUATE?

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SUMMARY

The amount of cash necessary for financial health and growth varies according to types of businesses and with individual companies. This Aid suggests some of the ways owner-managers can determine whether they have an adequate cash supply.

The amount of cash can be determined only by careful analysis of the business. To assure an adequate cash supply, the owner-manager needs records on which to prepare meaningful forecasts and reasonable budgets.

Only then can he control and conserve cash so that it will be available at the right time. Only then will he know whether his business will generate sufficient cash or whether he will need to borrow. Included is an adapted budget form which should be helpful in planning for, and keeping track of, the cash supply.

"How much cash does my business need?" is a question which often troubles owner-managers of small manufacturing companies. And rightly so because cash is the fuel which is necessary for operating the business.

The amount of cash which a company needs for profitable operation depends on the company itself because cash requirements vary according to the type of business. The amount which would be an adequate cash supply for one company may well be too small for another.

In thinking about cash needs, many managers use an old rule of thumb. It says that usually a company's cash balance should be equal to at least one-fourth of the company's current debts. However, if you operate blindly on this rule you may run into trouble.

Another method for determining cash needs is to compare industry ratios and statement studies, offered by trade publications, with your company's finances. But keep in mind that these ratios and statement studies are averages and should not be relied on solely when determining your own company's needs.

Companies have individual requirements and goals which have to be considered in order to ensure profitable operation. You'll need to make your judgment on facts which you can get from your past financial records.

After you have these facts, you'll need to: (1) decide whether your cash supply was adequate in the past, (2) estimate your future cash needs, and (3) take effective steps to control and conserve your cash for those future needs.

TWO KINDS OF CASH

An adequate cash supply for your company should be one which enables you to pay your current operating costs on time and to provide for future expansion costs. Thus you need to think about and provide cash for two kinds of costs.

First, you have to have WORKING CASH. Funds you use to buy raw materials, to pay wages, and to pay other day-to-day business expenses fall in this category. For most companies, they come from daily receipts--that is from cash sales and payments of accounts receivable.

Second, you have to have cash for CAPITAL expenditures--additions to, as well as replacements of, fixed assets such as your plant, equipment, and tools. Such cash may come from either a long-term loan or from daily receipts in excess of working cash requirements. If the latter source is used, it may be necessary to withhold the distribution of profits in the form of cash until enough cash is accumulated to meet the capital requirements.

An owner-manager should have a firm understanding of which portions of his cash he is going to use as capital cash and which as working cash. In his thinking, he should keep them separate. He should realize that cash on hand and in the bank must first be

set aside for outstanding obligations. The cash that remains may be used for new capital expenditures if the business warrants them.

A company's cash supply is the amount of money on deposit at the bank. (It also includes undeposited receipts and readily convertible securities such as U.S. bonds and notes.) Except in highly seasonal businesses or in extraordinary situations, it should take care of requirements for working cash. But, a company's cash by itself is not profit because there may be large unpaid debts which can eat up a large checking account balance.

On the other hand, profit--a good net income--cannot be used for additional working cash if it has been distributed to its owners and is no longer available for expenditure. Profit is an important goal, and you should keep it in mind constantly. However, don't let preoccupation with profit block your vision so that capital cash is not available for growth and expansion.

In providing an adequate cash supply, you should also think of: (1) possible future increases in operating costs because expanded sales will mean bigger bills for labor and raw materials, for example, and (2) possible future increases in your capital expenditures when you have outgrown your present plant and equipment.

PLANNING YOUR CASH SUPPLY

Your planning for an adequate cash supply should be done in three phases: (1) make a forecast, or estimate, of your future sales; (2) set up an operating budget based on your sales estimate; and (3) make a cash budget to show the amount of funds needed in order to carry on your operations.

Besides your basic books of account, the kinds of records you will usually need are: (1) sales records, (2) production cost records, and (3) monthly cash statements. These records help you determine the business (or cash) cycle in your company--how much money comes in from sales, how much goes out for raw materials, and so on. You use these records to provide you with information about your cash needs based on anticipated sales.

- Estimate Sales

Sales are the starting point in forecasting the future needs of your business. You make a careful estimate of your sales expectations. You base this estimate on your company's past performance as described in your financial records.

Keep in mind that the past is just a yardstick and does not take into account growth or any plans for expansion. So along with the facts from your records, take into consideration any expected changes in your business. For example, if your sales have increased by 5 percent each year for the past 3 or 4 years, you'd expect them to increase 5 percent next year if conditions stay the same. In making sales forecasts, you'll want to try to include some margin for unforeseeable events. For example, what happens if sales drop off 20 percent in the slack season rather than the 10 percent which is normal for your operation?

When you have an estimate of your total sales volume for next year, break it down by months. You'll need monthly figures when you determine what is an adequate cash supply.

- Operating Budgets

Once you have an estimate of your sales volume, you can set up a production budget. This budget will project the selling, manufacturing, and overhead costs based on your estimated sales.

In developing an operating budget, you start with your estimated monthly sales figures for the next 6 or 12 months. Figure how much each activity of your business will cost in order to make your expected sales goal. Your records of past expenses will serve as a guide. For example, if you spent $40,000 last year for the raw materials necessary to do $100,000 in sales and expect to do $110,000 in sales this year, you would need to budget $44,000 for raw materials--an increase of 10 percent in both sales and raw materials.

You then set a figure for other cash needs, such as labor, overhead, and selling expenses.

Some owner-managers find the advice of their keymen and foremen valuable when they work up operating budgets. These supervisors, for example, help to see that details about their departments are not overlooked.

- Prepare A Cash Budget

After you have your operating budget, you are ready to work up a cash budget. It is a plan which shows the cash receipts you expect to take in during a certain period and the expenditures you expect to make during that time. These figures should be on a monthly basis. Prepare a detailed forecast of the amount of cash you expect to take in and spend month-by-month to cover 1 year.

Some owner-managers who have never budgeted find it easier to start with a 6-months budget. They they use their experience from the first 6 months when developing the budget for the second 6 months. It is also a good idea to make a skeleton forecast for an additional 12 months. In this manner, you will have a plan for the next 2 years.

In preparing your cash budget, you use figures from yours sales forecast and your operating budget. If you've never prepared a cash budget, the sample on page 4 has been adapted for helping you to provide for adequate cash of both types--capital cash and working cash. This Aid deals mainly with the latter.

CONTROL AND CONSERVE

After you have set up your cash budget, your task will be that of seeing that your

company operates within it. If your budget estimates are good, the necessary amount of cash will be available at the right time.

Therefore, the owner-manager must see that his company lives within its sales, production, and cash budgets. At the same time, he must make sure of his supply of cash by seeing that his customers pay their bills promptly and by safeguarding funds after he receives them.

Company procedures should safeguard assets, especially those which are easily negotiable. Only you, or employees to whom you delegate spending authority, should be able to spend cash.

Control procedures should cover every expense item from purchasing to payroll checks. There should be a reasonable explanation for any sizable difference between actual and budgeted expenditure. Where there is, budgets should be adjusted and adhered to.

One of the most obvious ways of safeguarding your company's money is the separation of your personal funds from those of your business. Let your company pay you a salary and show that amount as an administrative expense item in your company's budget and accounting records. Then use a separate bank account for your salary and personal expenses. In paying themselves a bonus, good managers wait until the end of the year and draw from the profits which are left after the needs of their businesses are taken care of.

You may want to keep in mind also that the owner-manager's salary can offer a way to improve the cash position, especially in a fairly new company. By timing the drawing of his pay, he can sometimes keep his cash balance high on critical days in the month. For example, if you pay for raw materials on the first of the month, you may want to draw your salary check around the 15th after funds have come in from several of your slow paying customers.

Your methods for assuring an adequate cash supply should also cover credit which you give your customers. The owner-manager who allows customers to fall behind in their payments creates a drain on his cash balance. In effect, he is financing them when he cannot afford it.

If your need for cash is great around the first of the month, your credit policies should encourage customers to pay you near that time. Offering a discount for prompt payment, in many cases, enables a company to keep its money turning and thus operate with smaller cash balances.

Purchasing offers another way to save money. Teach your people to buy raw materials and other items at the best price. In delegating purchasing, make one person responsible. Thus you can avoid the waste which sometimes occurs when several persons buy items and none knows what the other is doing. Inventory and materials control are important in reducing confusion and duplication.

OVERCOMING TEMPORARY DEFICIENCIES

Even though you plan and control cash, there may be times when income from sales may not be great enough to cover your current bills. The problem: adjusting to a temporarily weak cash supply.

Sometimes you may be able to adjust by rearranging your billing cycle and by tightening your credit limits. At other times, you may need to arrange a short-term loan at your bank.

Usually, it is easier to do such borrowing when you plan for it. When you know ahead that your cash balance will be low at certain times of the year, discuss it with your banker and thus prepare him ahead of time.

A BASIS FOR GROWTH

Finally, maintaining an adequate cash supply is a basis for growth. Many owner-managers realize that it is good business not to distribute all their profits. They plow a large part of profits into expanding the business by using them for capital expenditures such as new machines and equipment.

In order to develop surplus cash which can be reinvested to provide additional profits, a company must, first of all, take in enough to pay its bills including periods when little, or no, money comes in from sales, for example, in a seasonal type of business. When such needs are provided for, the owner-manager can plan for growth.

He may wait until the end of the year to invest surplus cash in a new piece of equipment, for example. Or he may siphon some of it off during the year. Items 20, 21, and 22 in the sample budget on page 4 of this Aid are for your use in planning for, and keeping track of, such capital expense items.

Sometimes a business does not generate surplus cash fast enough so the owner-manager has to get his capital cash by long-term borrowing. He finds that it is easier to get such loans when he has maintained an adequate supply of working cash - one that enables him to build a reputation for paying his bills on time. Such a reputation makes a favorable impression with bankers, especially when they see that the owner-manager has built it by planning his cash supply.

Regardless of how you manage the details of your company's growth, keep in mind that an adequate cash supply is vital to expansion. Plan to keep close watch on your cash position. Inspect it periodically--every week, every 2 weeks, every month--according to the best time for your business. In this manner, you can make sure that cash is coming in, as you expected, and being used, as you planned.

CASH BUDGET
(for three months, ending March 31, 19__)

	January		February		March	
	Budget	Actual	Budget	Actual	Budget	Actual
EXPECTED CASH RECEIPTS:						
1. Cash sales						
2. Collections on accounts receivable						
3. Other income						
4. Total cash receipts						
EXPECTED CASH PAYMENTS:						
5. Raw materials						
6. Payroll						
7. Other factory expenses (including maintenance)						
8. Advertising						
9. Selling expense						
10. Administrative expense (including salary of owner-manager)						
11. New plant and equipment						
12. Other payments (taxes, including estimated income tax; repayment of loans; interest; etc.)						
13. Total cash payments						
14. **EXPECTED CASH BALANCE** at beginning of the month						
15. Cash increase or decrease (item 4 minus item 13)						
16. Expected cash balance at end of month (item 14 plus item 15)						
17. Desired working cash balance						
18. Short-term loans needed (item 17 minus item 16, if item 17 is larger)						
19. Cash available for dividends, capital cash expenditures, and/or short-term investments (item 16 minus item 17, if item 16 is larger than item 17)						
CAPITAL CASH:						
20. Cash available (item 19 after deducting dividends, etc.)						
21. Desired capital cash (item 11, new plant equipment)						
22. Long-term loans needed (item 21 less item 20, if item 21 is larger than item 20)						

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